



# **Memorandum**

California Public Employees' Retirement System

Date: July 19, 2005

To: Michael McCook

From: Børge Tangeraas, Investment Officer – Real Estate

Subject: Evaluation and recommendation on international public real estate securities investment, Global PREES

The purpose of this memorandum is to evaluate and recommend international investment for the Global Public Real Estate Equity Securities ("Global PREES") portfolio. Real Estate Staff recommends that the Extended Market Public Real Estate Equity Securities ("Extended Market PREES") policy be amended and renamed to allow for Global PREES exposure.

## **Background**

Now that the market for Domestic Real Estate Equity Securities ("Domestic PREES") is experiencing extensive yield compression as a result of capital flows and increased market efficiencies, it is time to look further for value creation and diversification benefits. Current research supports the case for a Global PREES allocation based on characteristics such as enhanced risk adjusted returns, low correlation between regions, and a larger universe. Also, increasingly larger international exposure in the System's private real estate portfolio requires global exposure to its public component for it to function as a complement to the total real estate portfolio.

## **The Case for Investing in Global PREES**

Benefits of Global PREES exposure mirror those of Domestic PREES such as high dividend yield, ample liquidity, attractive risk return characteristics, and exposure to real estate segments that is not available through direct real estate investing. However, investors in Global PREES can also reap the following benefits:

- The world's real estate markets are at different stages in the real estate cycle. Investing in a global portfolio allows investors to take advantage of those countries experiencing the best fundamentals at a particular point in time.
- Portfolio diversification. The global real estate markets offer low correlation among themselves as well as to other asset classes.

- Potential upside as countries convert to a REIT type structure. Property operating companies that convert to become a high dividend paying company with lower leverage levels tend to be financially rewarded in the public markets.
- Market inefficiencies. International markets tend to be less efficient in valuing public equity real estate securities than the public real estate market in the United States. Staff believes the System can profit from such inefficiencies.
- Larger universe. The universe for Global PREES is slightly more than double the size of Domestic PREES.

Investors in Global PREES may be confronted with the following potential issues:

- Liquidity may be an issue in certain securities, however, liquidity issues will be addressed in the constitution of CalPERS' custom index.
- Public equity real estate securities can be highly correlated with the broader equity market in certain markets. This tends to be the case when the real estate market capitalization represents a significant portion of the overall equity market cap such as in Hong Kong.
- Many countries are under-represented in terms of market capitalization. Germany and Italy, for example have very large real estate markets yet little representation in terms of capitalization and number of companies in Global PREES benchmarks.
- Investments in international securities will involve exposure to different currencies, which can increase the volatility of the investment.

The characteristics of the market for Global PREES are:

- Total global market capitalization of publicly traded real estate is estimated to be roughly \$550B represented by 405 constituents. Although this number only represents 2% of the world stock market, fifteen years ago the total market capitalization was more or less nonexistent and hence represents tremendous growth<sup>1</sup>. Much of this growth is a result of phenomenal growth in the U.S. and Australia which together account for 61% of the total market capitalization. Given high corporate and governmental ownership of real estate in Japan and Continental Europe and further developments of the REIT structure, real estate securitization is likely to expand to constitute closer to 4% of the over all stock market capitalization by the end of the decade representing over \$1 trillion in market capitalization according to research done by UBS.
- About 75% of the total PREES universe uses some type of a REIT structure. Approximately 24 countries in total offer or intend to offer real estate operating companies a REIT-like tax efficient vehicle<sup>2</sup>. All REIT-like

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<sup>1</sup> UBS Investment Research "Global Real Estate Analyser," June 2005

<sup>2</sup> Linda McDonald, "The Case for Global Real Estate Securities," February 2005

structures share commonalities such as a relatively high dividend ratios and more conservative leverage ratios than regular real estate companies. Also, they tend to focus more on operating income rather than development activities.

- Increasingly investors are holding PREES as part of their real estate allocations. In Australia typically 70% of all real estate allocations are held in the form of PREES. In the Netherlands the ratio is roughly 50/50, and in the U.S. the percentage held in PREES is as low as 15%<sup>3</sup>.

### **Implementation**

The Programs shall be externally managed and implemented through an RFP selection process.

Staff will change the benchmark from the Wilshire Real Estate Securities Index (“WRESI”) to an encompassing custom global equity real estate securities index in coordination with the Board’s Consultant. Staff believes that it would be beneficial to construct a global PREES custom index with the new benchmark taking the role as the investable universe.

Currency exposure should be reported in the same manner as other publicly traded international CalPERS programs.

The current asset allocation range for both PREES portfolios, as a percentage of the total real estate equity allocation, is currently between 0-15% based on market values. Staff recommends moving this range to be between 0-25%.

The Portfolio allocation within the range shall be at the prudent direction of the Senior Investment Officer, Real Estate. The factors considered in portfolio construction, asset allocation, and selection shall remain the same as in the current policies for Enhanced and Extended Market PREES.

### **Conclusion**

The globalization of listed real estate enables investors to participate in the phenomenal growth and increased liquidity that is expected over the next decade, especially in Europe and Asia.

Staff recommends amending the Extended Market Public Real Estate Equity Securities Policy to include non-U.S. listed companies, reflecting the market capitalization of the universe for Global Real Estate Equity Securities. In addition, staff recommends moving the combined asset allocation range for both PREES portfolios, as a percentage of total real estate equity allocation to widen from 0-15% to 0-25% to reflect the larger universe for Global Real Estate Equity Securities.

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<sup>3</sup> UBS Investment Research “Global Real Estate Analyser,” June 2005